DEPARTMENT OF EDUCATION -STUDENT FINANCIAL ASSISTANCE

VOLUNTARY FLEXIBLE
AGREEMENT (VFA)
PERFORMANCE METRICS – **DRAFT**

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I. Introduction

Representatives from the Modernization Partner Program ("Mod Partners") are assisting Student Financial Assistance ("SFA"), collectively "the Engagement Team," with developing performance measures for the Voluntary Flexible Agreement ("VFA") program. VFA contracts incorporate and modify the existing agreements between the Department of Education ("Education," "ED" or "the Department") and the guaranty agencies ("GAs") participating in the Federal Family Education Loan ("FFEL") program.

VFAs incorporate and modify the existing FFEL agreements between ED and the participating guaranty agencies. Established by the Higher Education Amendments of 1998 (P.L. 105-244) (HEA Amendments), the new agreements test new and innovative methods for carrying out the types of activities currently required of guaranty agencies in order to find more efficient and effective means of managing the FFEL program. There are four active FFEL guarantors that have entered into VFAs with ED:

- American Student Assistance [ASA]
- California Student Aid Commission [CSAC]
- Great Lakes Higher Education Guaranty Corporation [GLHEGC]
- Texas Guaranteed Student Loan Corporation [TGSLC]

The Secretary published a notice in the <u>Federal Register</u> on July 28, 1999, inviting proposals for VFAs from all interested guaranty agencies. Nine proposals were submitted and evaluated on the basis of various criteria including transferability, efficiency, use of new technology, and expected benefits. After extensive negotiations on the terms of the agreements, ED determined that the four agreements that were selected were cost-neutral, as required by section 428A(b)(2)(B) of the Higher Education Act of 1965, as amended (HEA).

Each of the four VFAs test different innovations within the FFEL program. The innovations have a common theme – to improve the efficiency of collections and to shift incentives from back-end collection of defaulted loans to the avoidance of defaults in the first place. Specifically,

- ASA's VFA focuses on "portfolio wellness" -- an approach that promotes the idea that an improved relationship between the borrower and the loan servicer or guaranty agency can remedy default and delinquency problems;
- CSAC's VFA implements programs that place a greater emphasis on default prevention and improving the collection process;
- GLHEGC's VFA replaces all of the Federal payments to the agency with a single performance-based fee indexed to the agency's ability to get delinquent borrowers to make payments and avert default; and
- TGSLC's VFA comprehensively modifies its payment structure to tie payments to improved performance, with increased emphasis on pre-delinquency and default aversion, in addition to locating, rehabilitating, and collecting on defaulted loans.

If successful, these approaches will support ED's overall goal to improve the integrity of the loan program through continued reductions in defaults. In its Report to Congress on the status of the

VFA Program, ED agreed to establish common, general measures for evaluating the performance of each VFA over the coming year. These include:

- analyzing default and delinquency rates to determine whether the VFAs have had a positive effect on lowering these rates;
- determining if the VFAs strengthen or weaken the overall financial structure of the guaranty agencies; and
- assessing the ability of guaranty agencies and ED to effectively administer the program without guaranty agency reserves.

ED will also determine whether the terms and conditions established in each VFA process are scalable and transferable to the wider FFEL community. Additionally, ED will consult lenders and schools participating in each guaranty agency's program to determine how they are affected by VFAs. FFEL program participants have expressed concern that there may be unintended consequences for their business processes as a result of the implementation of the agreements. ED will also consult with guaranty agencies that are not participating in a VFA to determine if the agreements have had an adverse impact on other guaranty agencies.

This report presents the initial draft set of performance measures that have been established by the Engagement Team. Most of the performance measures presented in this report are concise measures that utilize aggregated data that is already captured by the Department and used in some capacity by various business units within SFA. These measures will be compared to established benchmarks in order to ascertain the relative performance of the VFA GAs. One measure, the cost neutrality measure, addresses a specific issue identified in the regulations and in last year's report to Congress that the VFA Program would be cost neutral to the Department. To address cost neutrality, a more detailed analysis section is presented in this report. To this end, the report is organized as follows:

- **II. Individual VFA Performance Measures:** identifies, defines, and presents formulas for the VFA performance measures and also includes similar information for those performance measures that cannot be readily implemented, but could be considered as potential measures for future periods;
- **III. Analyzing Cost Neutrality of VFAs:** presents a comprehensive methodology for addressing cost neutrality and provides an example of such an analysis using arbitrary data;
- **IV. Interpreting Performance Measures through Benchmarking:** identifies various benchmarking techniques for interpreting the individual VFA performance measures;
- **V. Potential Next Steps:** identifies potential next steps relating to the implementation of the performance measures and automating the performance measurement process.

II. Individual VFA Performance Measures

Our approach resulted in a number of potential performance measures that would satisfy the objectives stated in the Introduction. Once identified and defined, we researched whether each measure could be implemented with data currently submitted by the VFA GAs or otherwise readily available. SFA's stated objective of identifying simple, concise, and easily implementable measures served as the foundation for the measures presented in this report. This objective is consistent with SFA's initiative to start computing these measures using March 31, 2002 data.

Our short-term objective was to identify viable measures that can be quickly implemented and tracked in time to incorporate meaningful performance information into the annual Report to Congress due September 2002. We also include potential future performance measures that are not quickly implementable due to a variety of system/data issues. These future performance measures could provide information that would allow a more comprehensive assessment of GA performance.

Four tables are presented in this Section:

- 1. **Table 1: Readily Implementable VFA Performance Measures:** presents those measures that will be computed by SFA to gauge the performance of the VFA's default aversion activities:
- 2. **Table 2: Other Readily Implementable Supplemental Performance Measures:** presents those measures that will be used by SFA to supplement the actual VFA performance measures (viewed in conjunction with other measures) or as a measure of a process that is specific to the VFA Program;
- 3. **Table 3: Measure Resulting from Cost Neutrality Analysis:** presents a measure that will be the result of an established methodology used to analyze the overall VFA program; and
- 4. **Table 4: Potential Future VFA Performance Measures:** presents those performance measures that were originally identified, but subsequently deemed not readily implementable due to internal system/data issues.

The measures presented in the four tables are absolute measures, meaning that their results are not stated in comparison to the results of the other 32 GAs or some other relative basis. There are numerous methods for incorporating a relative basis that would assist SFA in interpreting these results. Examples include comparing a VFA GA's current performance to a prior period, and comparing its performance to that of a non-VFA population. These benchmarking methods are provided in the final section of this report.

Table 1: Readily Implementable VFA Performance Measures

T_0	Table 1: Readily Implementable VFA Performance Measures				
	Performance Measure	Description/Explanation	Formula		
1	Dollar Percentage of Loans in Good Standing	Description "Dollar Percentage of Loans in Good Standing" includes any FFEL Program loan which is in repayment, but is not in default. This measure is stated as a percentage of the dollar volume of loans in repayment – and will include all loans in the GA's portfolio (not just loans entering repayment during the measurement period) Explanation Should indicate the success of a GA's ability to increase the dollar volume of loans in good standing (or conversely, to decrease default rate)			
2	Reinsurance Trigger Rate	Description Represents the total of reinsurance claims paid by the Secretary to a guaranty agency during the measurement period as a percentage of the amount of loans in repayment at the end of the preceding measurement period Explanation Complements the "Dollar Volume of Loans in Good Standing Measure" (similar to its converse) and is consistent with the computed rate used to determine if the GA is to receive a reduction in its reinsurance rate	Total Reinsurance Claims Paid by the Secretary to a Guaranty Agency during the Measurement Period Dollar Amount of Loans in Repayment at the end of Preceding Measurement Period		
3	Collections Recovery Percentage	Description Represents the total dollar amount of principal and accrued interest collected on defaulted loans during the measurement period as a percentage of the total dollar amount of principal and interest in default as of the beginning of the fiscal year Explanation Monitors the GA's ability to effectively recover funds from its defaulted loan portfolio	Dollar Volume of Collections on Defaulted Loans During the Measurement Period Σ [(Amount of Outstanding Principal Balance), (Amount of Outstanding Accrued Interest Balance), (Amount of Ending Balance on Claim of Other Fees)] for Loans in Default at the Beginning of the Fiscal Year		
4	GA Collections Recovery Variance From SFA's Collections Recovery Percentage	Description Represents the difference between the GA's Collections Recovery Percentage (Measure #3 above) and SFA's Collections Recovery Percentage on defaulted loans that were assigned to SFA by the GA Explanation Monitors the GA's ability to effectively recover funds relative to SFA's ability – since the GA's have the same access to collection methods/tools as does SFA and that SFA's assigned portfolio primarily consists of loans that have been in default for more than four years, it is expected that the GA should have a higher recovery percentage than SFA	GA's Collections Recovery Percentage on its Default Portfolio (same as Measure #3) = minus SFA's Collections Recovery Percentage on Defaulted Loans Assigned to it by the GA		

Table 1 presents those performance measures designed to gauge the individual VFA GA's success at executing its default aversion activities. The measures will be used to assess whether or not the VFA program is accomplishing its objectives. Table 2 (below) presents additional performance measures that will also be monitored by SFA, however, these measures do not gauge the VFA GA's success at executing its default aversion activities. Rather, these measures assist SFA in monitoring the impact of the VFA program on other program areas (e.g., market share) or assist SFA in interpreting the measures in Table 1 (e.g., data pass rate).

Table 2: Other Readily Implementable Supplemental Performance Measures

ıuv	able 2: Other Readily Implementable Supplemental Performance Measures				
	Performance	Description/Explanation	Formula		
	Measure				
1	Market Share Percentage	Description Market share will be measured by "Net Guarantees." The measure represents the amount of new net guarantees made in the current measurement period compared to the prior period as a percentage of the total GA community's net guarantee portfolio (the formula in the next column will be computed for the current period and prior period to determine the periodic change) Explanation Monitors the GA's market share and could be aggregated to compare how the four VFA GAs are either losing or gaining market share relative to the other 32 standard GAs	(Dollar Amount of Net Guarantees for Current Period for Individual GA) (Dollar Amount of Net Guarantees for Current Period for the Total GA Community)		
2	Data Pass Rate for NSLDS	Description The percentage of records entered correctly by the VFA as a percentage of the total number of possible entry records Explanation Can be used to supplement interpretation of other measures that use NSLDS data and provides another incentive for the GAs to focus on the integrity of their data submissions	# of Loans with all data accepted by NSLDS Total # of Loans submitted to NSLDS		
3a	VFA Escrow Account Days Difference Measure	Description For the three VFA GAs that have a federally established escrow account (Texas, Great Lakes, and ASA), the average number of days between the claim payment from the GA to the lender and the reinsurance payment from ED to the GA Explanation Indicates whether the alternative financing arrangement of using escrow accounts is working efficiently and could potentially be installed for all GAs	Average [Number of Days Between Claim Payment and Reinsurance Payment]		
3b	VFA Escrow Account Usage Measure	Description For the three VFA GAs that have a federally established escrow account (Texas, Great Lakes, and ASA), the number of times the VFA GA extracted funds from its escrow account Explanation Indicates whether the alternative financing arrangement of using escrow accounts is working efficiently and could potentially be installed for all GAs	= Number of Times Funds were Extracted from Escrow Account		

Table 3: Measure Resulting From Cost Neutrality Analysis

	Performance Measure	Summary of Methodology Steps	Formula	Interpretation of Formula Result
1	Cost Neutrality Ratio	Cost neutrality means that the incremental cash flow realized by the VFA GA should equal the incremental cost savings realized by the Secretary as a result of the VFA GA's default aversion activities. Based on this definition, a performance measure that addresses cost neutrality should incorporate two components: • Incremental Cash Flows for VFAs: the difference between the net cash flows (claims, collections, fees) between the actual VFA GA cash flows and the estimated net cash flows that the VFA would have realized assuming the VFA GA was operating under a standard GA agreement; • Default Cost Savings of VFA Program: comprised of the following two components: (i) Cost Savings from a Lower Default Rate, and (ii) Cost Savings from a Lower Cost of Default.*	Incremental Cash Flows for VFAs Default Cost Savings of VFA Program	=1:The VFA Program is perfectly cost neutral, meaning that the additional cash flows being realized by VFAs over non-VFAs is equal to the cost savings being realized by the Department as a result of the VFA GA's default aversion activities <1: The Secretary is realizing more cost savings from the VFA GA's default aversion activities than the VFA GAs are realizing in additional cash flows >1: The VFA GAs are realizing more additional cash flow than the cost savings that are being realized by the Secretary due to the VFA GA's default aversion activities

^{*}A specific methodology for computing the "Incremental Cash Flows for VFAs" and the "Default Cost Savings of the VFA Program" is presented in Section 3 of this report (for the purposes of the example shown in this report, it is assumed that the VFA program would result in a lower default rate and a lower cost of default as compared to the average standard GA).

Table 4: Potential Future VFA Performance Measures

Ta	able 4: Potential Future VFA Performance Measures					
	Performance	Description/	Formula	Status*		
	Measure	Explanation				
1	Pre-Claims Assistance (PCA) Percentage	Description Represents the total dollar amount of requests for pre-claim assistance as a percentage of the dollar volume of loans in repayment as of the beginning of the measurement period Explanation Monitors the GA's ability to prevent delinquency by reducing the amounts requested for pre-claim assistance	1% of Principal and Accrued Interest Balances on Loans submitted for pre-claim assistance Σ [(Amount of Outstanding Principal Balance), (Amount of Outstanding Accrued Interest Balance),] for Loans in Repayment as of the Beginning of the Measurement Period	Data Not Readily Available The Default Aversion Fee is only captured annually in the Financial Management System (FMS) and may not be captured at all for the VFAs that do not receive this fee as part of their performance-based compensation. The amount submitted annually is already net of default reimbursement, therefore, there is no current way to measure the success of preclaims assistance. If SFA wanted to determine the viability of implementing this measure, the following steps could be taken:		
2	Success of Pre- Claims Assistance Percentage	Description Represents the total dollar volume of loans that received PCA and subsequently did not default as a percentage of the dollar volume of loans that received pre-claim assistance when a loan receives PCA and subsequently defaults, the GA must submit a refund to Education in the amount equal to 1 percent of the claim on that loan; if the loan does not default, the GA keeps the PCA Explanation Monitors the GA's ability to avert default – this measure is consistent with a version of the cure rate that could be applied to all GAs if the necessary data is captured electronically within SFA's systems	1% of Claims on Loans that Received Pre-Claim Assistance and Subsequently Defaulted (for a given measurement period, this amount would be tracked roughly 180-270 days after the measurement period to determine subsequent default) 1% of Principal and Accrued Interest Balances on Loans Submitted for Pre-Claim Assistance During the Measurement Period	Work with Bruce Zimmerman from Great Lakes, who is looking into the viability of the uniform cure rate Schedule and hold a conference call with the Texas VFA to fully understand cure rate computation Develop a one-page synopsis of the computation, the individual data elements required to calculate it, and specific questions to the GA community on their ability to capture the necessary data Distribute the one-page synopsis to all GAs for feedback Summarize GA feedback on likelihood and speed of implementation		
3	Dollar Volume of Loans in Consolidation Percentage	Description Represents the dollar volume of loans that have been consolidated during the measurement period as a percentage of the dollar volume of loans in repayment as of the beginning of the measurement period Explanation Monitors the GA's use of consolidations as a means to avert default	$\sum [(\text{Amount of Outstanding Principal Balance}), (\text{Amount of Outstanding Accrued Interest Balance})] for Loans that have been Consolidated During the Measurement Period \sum [(\text{Amount of Outstanding Principal Balance}), (\text{Amount of Outstanding Accrued Interest Balance}),] for Loans in Repayment as of the Beginning of the Measurement Period$	Data Not Readily Available Able to identify loans that have been consolidated in NSLDS, but the dollar amounts are set to zero for loans that have been consolidated. NSLDS does not maintain historical balances.		

^{* &}quot;Data Not Readily Available" means that our research found that some data necessary to compute the measure was missing or is not accessible at this time.

	Performance	Description/	Formula	Status*
	Measure	Explanation		
4	Default Composition of Loans in Consolidation	Description Represents the dollar volume of consolidated loans that were in default prior to being consolidated during the measurement period as a percentage of the total dollar volume of loans that were consolidated at the beginning of the measurement period Explanation Monitors the GA's consolidation activity with respect to consolidating defaulted loans versus consolidating non-defaulted loans	(Percentage of Loans with a Loan Status Code in NSLDS indicating Default Prior to Consolidation) x (Σ [(Amount of Outstanding Principal Balance), (Amount of Outstanding Accrued Interest Balance)] for Loans that have been Consolidated as indicated by FMS Σ [(Amount of Outstanding Principal Balance), (Amount of Outstanding Accrued Interest Balance)] for Loans that have been Consolidated as indicated by FMS at the Beginning of the Measurement Period	Able to identify loans that have been consolidated and were in default prior to consolidation in NSLDS, but the dollar amounts are set to zero for loans that have been consolidated and NSLDS does not maintain historical balances
5	Performance of Consolidated Loans Measure (Direct Loan)	Description Represents the dollar volume of consolidated loans (Direct Loans) that are currently in default as a percentage of the total dollar volume of loans that were consolidated Explanation Monitors the extent to which VFA GAs consolidate loans through the Direct Loan Origination System, when the loans subsequently default	Was not = determined	Data Not Readily Available The Direct Loan Origination System and the Direct Loan Servicing System do not currently transfer information that would be needed to track the performance of loans that have been consolidated by a specific GA

^{* &}quot;Data Not Readily Available" means that our research found that some data necessary to compute the measure was missing or is not accessible at this time.

III. Analyzing Cost Neutrality of VFAs

Background

As stated in SFA's Report to Congress in September 2001, the Department of Education developed cost projections which estimated that the VFA program would be cost neutral; in other words, it was expected that each VFA program would not exceed the cost to the Secretary under the standard guaranty model. Specifically, cost neutrality means that the incremental cash flow realized by the VFA GA should equal the incremental cost savings realized by the Secretary as a result of the VFA GA's default aversion activities.

The challenge with conducting such an analysis is the cost savings to Education would not be instantaneous and may not be reflected in today's actual numbers. The cost savings would likely be realized over time as the VFA GA's develop greater efficiencies in their default aversion efforts. The expectation is that the VFA GAs should demonstrate greater improvement in default aversion as compared to standard GAs for the first few years of the Program. The relative improvement would likely moderate until a constant spread between the VFA GA's default rate and the standard GA's default rate is realized. This expected difference between the average VFA GA's default rate and the average GA's default rate would comprise the majority of the cost savings that would be realized by the Department.

The cost neutrality analysis could be done in two ways depending on whether the Department thinks that the true impact of the VFA program is currently represented in today's actual numbers or whether the impact is still growing. If the former assumption is followed, the analysis presented in this section could be conducted using today's actual numbers. If the latter assumption is followed, the analysis would have to incorporate future improvements in the default rates for VFAs and future changes in the cash flows realized by the VFAs in order to estimate cost neutrality today. For purposes of this report, the former assumption is followed.

Based on this definition, a performance measure that addresses cost neutrality should incorporate two components:

- Incremental Cash Flows for VFAs: the difference between the net cash flows (claims, collections, fees) between the actual VFA GA cash flows and the estimated net cash flows assuming the VFA GA was operating under a standard GA agreement;
- **Default Cost Savings of VFA Program:** comprised of the following two components: (i) Cost Savings from a Lower Default Rate (as described earlier in this Section), and (ii) Cost Savings from a Lower Cost of Default.

The performance measure would represent the Incremental Cash Flow stated as a ratio to the Incremental Cost Savings ("Cost Neutrality Ratio"). Pure cost neutrality should result in a perfect negative correlation (i.e., the incremental cash flow (cash outflow to the Secretary) should be perfectly offset by the incremental cost savings (cash inflow to the Secretary)). The following section describes this analysis.

Cost Neutrality Analysis

This section presents the steps associated with conducting a cost neutrality analysis of the VFA Program. While reading, please reference the following tables that present an example of such an analysis on the VFA Program (data used is arbitrary). There are three main tables in the below example with the first two corresponding to the two components mentioned above: (a) Incremental Cash Flows for VFAs and (b) Default Cost Savings for VFA Program. The third tables display the calculation of the Cost Neutrality Ratio. These tables are described in more detail following the example (Please note that the following example uses arbitrary data (shown in italics). Numbers not in italics are a result of a calculation using the arbitrary data).

A. Incremental Cash Flows for VFAs --- Net Cash Flow Comparison

	VFAs	Non-VFAs
a) Net Claims	\$(25)*	\$(27)*
b) Net Collections	\$15*	\$12*
c) Fees	\$100*	\$45*
Net Cash Flow (a + b + c)	\$90	\$ 30
*arbitrary data is shown in italics		
cremental Cash Flow for VFAs	\$ 60	

B. Default Cost Savings for VFA Program

	VFAs	Non-VFAs
S1 Defaulted Loan	\$1.00	\$1.00
Outflow to GAs for Defaulted Loans ("Default Cost Per \$1 Defaulted Loan")*	\$0.75	\$0.76
* the steps required to quantify this amount is described later in this report		
the steps required to quantify into amount is described taler in into report		
2. Variance in the Default Volume % Estimation		
	VFAs	Non-VFAs
	VFAs	Non-VFAs
2. Variance in the Default Volume % Estimation	VFAs \$30,000*	Non-VFAs \$150,000*
2. Variance in the Default Volume % Estimation End of Current Measurement Period		

Calculation of Total Default Cost Savings of the VFA Program	
Cost Savings from Lower Default Rate	
a) Variance in Default Rate (VFA default rate minus Non-VFA default rate)	0.19%
b) \$ Volume of Loans in Repayment for VFA (taken from table 2 above)	\$30,000
c) Default Cost Per \$1 Default Loan for Non-VFA (taken from above)	\$0.76
d) Cost Savings from Lower Default Rate (a * b * c)	\$43
ii. Cost Savings from Lower Cost of Default	
e) Variance in Cost of Default (VFA minus Non-VFA)	\$0.01
f) \$ Volume of Loans in Default for VFA (taken from above)	\$1,744
g) Cost Savings from Lower Cost of Default (e * f)	\$17
Default Cost Savings of VFA Program (d + g)	\$60
* represents the extra cost savings of the VFA as a percentage of each \$1 of defaulted loan	ıs

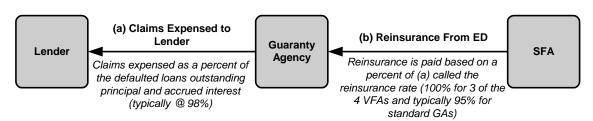
C. Calculating the Cost Neutrality Ratio

Final Results		
a) Incremental Cash Flow for VFAs	\$60	
b) Default Cost Savings of VFA Program	\$60	
Cost Neutrality Ratio* (a / b)	1.0	
*A ratio of "1" means perfect cost neutrality; a ratio < 1 means that the Secretary is realizimore positive cash flows; a ratio > 1 means that the Secretary is not realizing enough cost s being realized by the VFAs.		

A. Net Cash Flow Comparison

The purpose of this step is to compare total cash flows realized by the GA under the VFA and estimated cash flows that would have been realized under a standard GA agreement. As the example shows, the result of this comparison is the "incremental cash flow for VFAs." For the purposes of this analysis, cash flows include those net inflows and outflows that are impacted by the VFA structure (i.e., fees, reinsurance rates on claims, and collections). We have identified these three primary categories of cash flows that are common in each VFA. The sum of the following three cash flow categories is calculated for a GA under the VFA and is estimated for the same GA under a standard GA Agreement:

1) Claims



(c) Reinsurance Complement = (a) - (b)

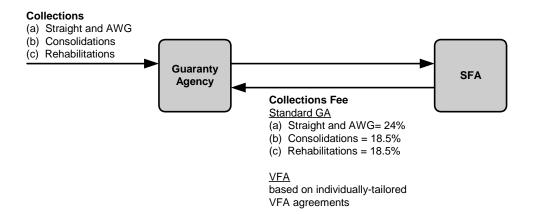
All guaranty agencies are entitled to receive reinsurance from the Department of Education for claims paid to lenders by the GAs for defaulted loans. The rate at which they are reinsured can vary for each VFA and the standard GAs (this rate is referred to as the "reinsurance rate"). The difference between claims expensed to lenders and the reinsurance amount from ED equals the amount not reimbursed. This is known as the "reinsurance complement."

For instance, a standard GA's typical reinsurance rate is approximately 95 percent of claims paid to lenders. If a VFA GA's reinsurance rate is 100 percent of claims, this difference between the reinsurance rates represents a real cash flow variance between the standard GA structure and the VFA structure that should be captured when conducting this comparison.

A summary of how the net cash flow associated with claims is determined for the VFAs and estimated for the non-VFA follows:

VFA	Non-VFA
(a) Claims expensed to lenders➤ Taken directly from Forms 2000	(a) Claims expensed to lenders➤ Taken directly from Forms 2000
(b) Reinsurance from ED➤ Taken directly from Forms 2000	 (b) Reinsurance from ED Estimated by multiplying a standard GA's average reinsurance rate by claims expensed to lenders
 (c) Reinsurance Complement Computed by taking the difference between claims paid to lenders and reinsurance from ED 	 (c) Reinsurance Complement Computed by taking the difference between claims paid to lenders and reinsurance from ED

2) Collections

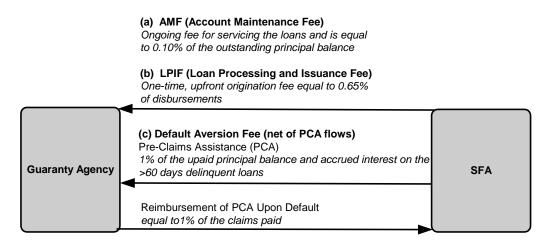


All guaranty agencies retain a certain portion of straight collections, administrative wage garnishments (AWG), and collections on rehabilitated and consolidated loans. This portion can vary for VFAs according to their agreement. For standard GAs, the portion retained on collections is typically 24 percent of straight collections and AWG and 18.5 percent of consolidated and rehabilitated collections. Under the various VFA structures, GA retention on collections can vary based on specific criteria designed to create incentives for GAs to manage the collections process more efficiently. This difference between GA retention rates on collections represents a real cash flow variance between the standard GA structure and the VFA structure that should be captured when conducting this comparison.

A summary of how the net cash flow associated with collections is determined for the VFAs and estimated for the non-VFA follows:

VFA	Non-VFA
Dollar Amount of Collections	Dollar Amount of Collections
➤ Taken directly from Forms 2000	Uses the average collections recovery percentage of a Non-VFA and applies it to the principal and accrued interest balances of the VFA's default portfolio
GA Retention of Collections	GA Retention of Collections
➤ Taken directly from Forms 2000	Separate collections fields from Forms 2000 are multiplied by an average GA Retention rate for each field:
	24 percent of straight collections and administrative wage garnishments
	18.5 percent of collections on rehabilitated and consolidated loans

3) Fees



Standard GAs are paid the following fees:

- Account Maintenance Fee ("AMF"): represents an ongoing fee for servicing the loans and is equal to 0.10 percent of the outstanding principal balance
- Loan Processing and Issuance Fee ("LPIF"): represents a one-time, upfront origination fee equal to 0.65 percent of disbursements
- **Default Aversion Fee ("DAF"):** represents an ongoing fee paid by Education to compensate GAs for efforts relating to default aversion and is equal to one percent of the principal and accrued interest of the loans requesting assistance (this fee is reimbursed by the GA to Education for loans that subsequently default)

Each VFA GA is paid a performance based fee as defined in its individual Agreement. These fees differ among the VFA GAs. The differences are captured in this measure. In order to compare the GA fee structure with the VFA fee structure, we must estimate what the standard GA fees would have been based on data currently submitted.

Estimating the AMF and LPIF for the GAs is relatively straightforward (in most instances, these fees would be the same as was paid to the VFA GA), however, the default aversion fee is challenging because there is no direct way to identify how much of the performance based fee was comprised of the default aversion fee and no direct way to split up the default aversion fee into its two primary components: (1) pre-claim assistance (PCA), and (2) reimbursement of PCA upon default. Therefore, the DAF that the VFA GA would have received if it operated under a standard GA agreement must be estimated.

To provide a reasonable estimation of DAF, SFA could try to identify a historic relationship between DAF and some other measure (e.g., balance of default portfolio or balance of delinquency portfolio). If DAF has historically been an average percentage of the GA's default

portfolio, SFA could assume that this relationship would persist in the future. Therefore, this percentage could be applied to the VFA GAs current default portfolio to estimate what the DAF would have been for a non-VFA.

A summary of how the net cash flow associated with fees is determined for the VFAs and estimated for the non-VFA follows:

VFA	Non-VFA
AMF	AMF
If applicable, part of Performance Based Fee	Calculated as 0.10 percent of the outstanding principal balance of outstanding loans, which is available in NSLDS
LPIF	LPIF
 If applicable, part of Performance Based Fee 	Calculated as 0.65 percent (0.40 percent starting FY 2003) of the amount of disbursements on new loans, which is available in NSLDS
Default Aversion Fee	Default Aversion Fee
If applicable, part of Performance Based Fee	 Calculated as a percentage of some other measure (e.g., balance of default portfolio or balance of delinquency portfolio)
Performance Based Fee	•
> Taken directly from FMS	

The sum of the three cash flow areas discussed above (claims, collections and fees) are calculated for the guaranty agency as a VFA (based on invoice and monthly data currently submitted by the VFA GA) and as a standard GA (estimated based on monthly data currently submitted by the VFA GA and based on simplifying assumptions relating to activity).

B. Default Cost Savings Comparison

In order to interpret the result of the Net Cash Flow Comparison, the result must be compared to the cost savings associated with an improved default rate and potentially cheaper cost of default for VFA GAs. Ultimately, this analysis should answer the question, "was the additional performance-based compensation to the VFA GAs matched by a corresponding increase in default cost savings to the Secretary resulting from the VFA GA's default aversion activities?"

To accomplish this objective, the default cost savings comparison section of the example displays three tables. These tables represent the three primary steps for estimating default cost savings.

1) Default Cost Estimation

The table shown in the example presents the "Default Cost Per \$1 Defaulted Loan." This section will describe the steps to computing this amount. The first step is to estimate the cost to the Secretary for every \$1 loan that defaults. In other words, when a loan defaults, what costs are incurred by the Secretary that are never recouped. In addition, for the purposes of this analysis, do these costs differ between VFA GAs and standard GAs? As is demonstrated below, the answer is yes due to the differences in reinsurance rates and GA retention rates on collections. We estimated default cost by analyzing two primary components and compared these components between the VFA structure and the standard GA structure. The two components are:

- i. Reinsurance Claims (Net of the Secretary's Equitable Share of Collections): SFA reimburses the GA a percentage of the claims paid to lenders. This percentage may differ between VFA GAs and standard GAs. Upon collection of funds on the defaulted loan, a portion of those collections ("Secretary's Equitable Share") is reimbursed to SFA. This share could also differ between VFA GAs and standard GAs. In addition, this share will be impacted by the GAs' ability to recover collections; therefore, the average collection recovery percentage will be used as part of this analysis. For this component, the cost of a defaulted loan equals the reinsurance paid to the GA less the Secretary's Equitable Share on collections.
- ii. Opportunity Cost of the Amount in (i): The Secretary's Equitable Share is not reimbursed to SFA at the same time reinsurance is paid to the GA. In many cases, this process could take months to years. Therefore, there is an opportunity cost on the Secretary's Equitable Share associated with the time between when reinsurance is paid and when the Secretary's Equitable Share is reimbursed. This opportunity cost equals the interest that could have been earned on the Secretary's Equitable Share during this time variance.

An example of estimating these two components is shown below (Please note that the following example uses arbitrary data (shown in italics). Numbers not in italics are a result of a calculation using the arbitrary data):

	To	otal
Calculation of Default Cost	VFA	Non-VFA
a) Defaulted Loan Volume	\$1.00*	\$1.00*
i. Reinsurance Claims (Net of the Secretary's Equitable Share of Collections)		
b) Claims Paid to Lender (usually at 98% of default volume)	\$0.98	\$0.98
c) Reinsurance Paid to GA by ED (% of Claim paid by GA to Lender)	\$0.97	\$0.93
Collections on Defaulted Loan		
d) Average Collections Recovery Percentage ("ACRP")	31%	30%
e) Collections on Defaulted Loans (a * d)	\$0.31	\$0.30
f) Amount of Collections Retained by GA (assumed GA Retention Rate)	\$0.05	\$0.07
g) Amount of Collections Reimbursed to ED, or Secretary's Share (e - f)	\$0.26	\$0.23
h) Reinsurance Claims, Net of the Secretary's Share of Collections $(c-g)$	\$0.71	\$0.70
ii. Opportunity Cost of Net Amount Paid to GA		
j) Average # of Days Between Reinsurance Paid and Collections	720	1,080
k) Average Interest Rate on Federal Fund (Opportunity Cost Rate)	3%	3%
1) Opportunity Cost (h * k * j/360)	\$0.04	\$0.06
Fotal Default Cost (h + l)	\$0.75	\$0.76
Note: Arbitrary data is shown in italics		

2) Variance in the Default Volume Percentage Estimation

The primary savings that will likely be realized by the Department will be the result of a lower default rate for the VFAs as compared to the standard GAs. Assuming consistency across regions on default activity and assuming equal portfolio risk levels for all GAs, the difference between the default rates should represent the impact of the VFA operating structure and their respective default aversion activities.

As mentioned in the introduction to this Section, the impact of the VFA program would not be instantaneous. The Program is designed to help reduce default rates relative to the market (i.e., the other 32 GAs), but this default rate variance could take time before finding an equilibrium, or a constant default rate variance. In the example provided in this report, an instantaneous shift was assumed; however, when using actual numbers, SFA should factor in improvement in this variance for future years and should estimate the timing and degree of this variance for the purposes of this analysis.

3) Calculation of Total Default Cost Savings of the VFA Program

The final step in estimating the Default Cost Savings is to simply add the results of (1) and (2) above. The two primary sources of cost savings is the impact of the differences between (1) the cost of default, and (2) the default rates.

C. Calculating the Cost Neutrality Ratio

The Cost Neutrality Ratio equals the quotient of the following two components:

- 1. Numerator: Incremental Cash Flows for VFAs (described in Part A of this Section)
- 2. *Denominator:* Default Cost Savings of VFA Program (described in Part B of this Section)

The results of this ratio should be interpreted as follows:

Result	Interpretation
= 1	The VFA Program is perfectly cost neutral, meaning that the additional cash flows being realized to VFAs over non-VFAs is equal to the cost savings being realized by the Department as a result of the VFA GA's default aversion activities.
< 1	The Secretary is realizing more cost savings from the VFA GA's default aversion activities than the VFA GAs are realizing in additional cash flows.
> 1	The VFA GAs are realizing more cash additional cash flow than the cost savings that are being realized by the Secretary due to the VFA GA's default aversion activities.

IV. Interpreting Performance Measures through Benchmarking

In order to provide a basis for evaluating the performance of the VFA GAs under their agreements, the performance measures should be compared to benchmark information. For example, the measure of the dollar percentage of loans in good standing as of a certain date does not provide much interpretative value by itself. A performance measure percentage could be compared to the VFA GA's prior period percentage in order to assess whether the VFA GA's performance has improved or deteriorated.

Establishing an appropriate benchmark could require significant analysis. An appropriate benchmark should have a similar risk profile and exposure to market events to the entity being compared to it. When a measure is stated as a variance to the benchmark (e.g., peer group benchmark – see below), the result would ideally isolate that entity's ability to perform without being impacted by general market changes that would impact all the entities' performance.

Benchmark Types

1. Prior Measurement Period

In this benchmark, the VFA GA's current period performance will be compared to its performance in a prior period. For example, the percentage of a VFA GA's loans in good standing as of 11/30/01 could be compared to that VFA GA's loans in good standing as of 11/30/00.

Advantages:

- Allows easy comparison of changes over time
- Easy to identify and interpret trend information

Disadvantages:

- May not isolate the cause of the change in performance. While a change can be identified, the change may be due to an external factor, such as a deteriorating economic conditions.
- Does not show how the change compares to a wider peer population's change
- Must maintain historical data to compute

2. Peer Group Comparison

In this benchmark, the VFA GA's results are compared to the performance of a related GA population.

Advantages:

• Allows the reviewer to assess whether a change in a performance measure is unique to the specific GA or whether there is a factor that is influencing the performance of all GAs within the peer group

Disadvantages:

• If the chosen peer group is not representative of the overall population, the comparisons may be misleading

We have identified several peer groups that could be used. In any benchmark comparison, the peer group should be carefully chosen so that the comparisons are meaningful and valid. For example, GAs are generally required to guarantee in-state loans, but they have some autonomy to select which out-of-state loans to guarantee. Due to this selection process, the default rate for out-of-state loans will likely differ from in-state loans. Therefore, it may be desirable to isolate out-of-state loans from in-state loans.

The following table lists other possible peer groups that can be affected by varying default activities:

Peer Groups	Definition	Reason for Comparison
Public School	Loans guaranteed for	Since tuitions for private schools can be considerably
vs. Private	public school	higher than public schools, the likelihood of default
School	attendance vs. private	could differ for students graduating from each type of
	school attendance	institution.
In-State vs.Out-	Loans guaranteed for	Out-of-state loans may perform better than in-state
of-State	attendance in an in-state	schools due to the GA's ability to selectively approve
	institution vs. an out-of-	out-of-state loan.
	state institution	
Geography	GAs within a certain	The portfolio of the four VFA GAs likely varies
(National,	geographical area	considerably due to state size, type and number of
Regional, State)	(nation, region, state)	schools, regional economic factors, etc.; therefore, the
		default activity within each region could also differ.
Repayment	Year in which the loan	Default activity varies based on the year the student loan
Year	enters repayment	enters repayment – it may be misleading to compare two
		GAs where one GA's portfolio consists primarily of
		loans that entered repayment 5 years ago to another
		GA's portfolio that consists primarily of loans that have
		just entered repayment this year.

3. VFA versus Non-VFA Comparison

In this benchmark, the VFA GA's performance is compared to a pre-defined baseline index that represents the GA's performance prior to becoming a VFA GA. This benchmark may be useful in assessing the financial impact of the VFA agreements.

Advantages:

Provides data that is integral to the analysis of the financial impact of the VFA GAs

Disadvantages:

• This benchmark requires the comparison of current period performance measures to the VFA GA's performance during the pre-determined baseline period. If the use of the VFA by the GAs fundamentally changes their operation, this comparison may have less value.

Initial Feedback from the Guaranty Agencies

Based on comments received by SFA from the GAs at a conference in mid-January, the GAs suggested benchmarking the four VFA GAs to a benchmark consisting of the 32 remaining GAs. In determining whether or not this benchmark is appropriate for comparison purposes, we should address the following questions:

- (a) Do the VFA GAs have a similar risk profile compared to the other 32 GAs?
- (b) Do the VFA GAs have similar exposure to market/economic events compared to the other 32 GAs?
- (c) Do the VFA GAs operate under similar regulatory environment as the other 32 GAs?

If the answer to any, some or all of these questions is "No," SFA may want to research some of the more refined benchmark types presented above. In addition, the GAs also expressed an interest in accessing their respective performance results compared to national averages in anonymity.